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409A MANDATES FOR EMPLOYEE SEVERANCE AGREEMENTS

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I. Background on Section 409A

Section 409A of the Internal Revenue Code, as amended ("Section 409A"), imposes new requirements on deferred compensation arrangements. Section 409A was enacted by Congress as part of the American Jobs Creation Act of 2004, in response to Congress' determination that executives had gained too much control over their deferred compensation. Section 409A governs the manner in which compensation is deferred and how deferred amounts are paid or distributed. Amounts subject to Section 409A that are deferred under a nonqualified deferred compensation arrangement are subject to current income taxation, unless the nonqualified arrangement complies in form and in operation with the election, distribution and acceleration requirements of Section 409A.

In April 2007, the Internal Revenue Service issued final regulations on the implementation of Section 409A. The final regulations provide that an amount is considered deferred before January 1, 2005, and thus, is not subject to Section 409A, if the service provider had a legally binding right to be paid the amount and the right to the amount was earned and vested as of December 31, 2004. Additionally, the final regulations required all deferred compensation arrangements to be in compliance by January 1, 2008.

A deferral of compensation exists when there is a legally binding right in a tax year to compensation that is payable in a later year. A legally binding right can exist even if payment of the compensation is subject to contingencies, such as continued service or termination of service. Deferred compensation can include bonus plans, long-term incentives, supplemental executive retirement arrangements ("SERPS"), equity compensation, elective deferrals, employment agreements, stock options and severance arrangements. Specifically excluded from coverage are qualified employer plans (including 401(K) plans and IRAs), bona fide sick leave, vacation leave, death benefit plans, and certain medical expense reimbursement arrangements.

II. Deferred Compensation Requirements

To comply with Section 409A, the material terms of the deferred compensation arrangement must be in writing and must include the amount of (or method or formula for computing) the deferred compensation and the time and form of payment.

Once subject to Section 409A, any payment of deferred compensation can only be paid upon certain permissible events, including:

1. At a fixed time or scheduled specified under the plan;
2. Upon the employee's separation from service (employees of public companies must wait an additional 6 months from the separation to begin receiving payment or benefits, *see below*)
    a. Once an employee has terminated employment, then that date will be deemed the separation from service date

   b. Even if the employee and employer have entered into an agreement requiring the employee to continue to perform minimal services or to be available to perform services, the employee is deemed to have separated from service.
3. The employee's death;
4. The employee's disability;
5. A change in the ownership or effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation; or
6. The occurrence of an unforeseeable emergency.

Except in limited circumstances, Section 409A does not permit compensation subject to Section 409A to be paid prior to the permissible payment event or prior to the times set forth in a written arrangement.

III. Penalties for Noncompliance

Section 409A imposes significant penalties for noncompliance. An employee who is party to a noncompliant agreement is subject to the following penalties:

- The employee will be subject to income tax on all deferred amounts, whether or not currently distributable;
- All payments that fail to comply with Section 409A are subject to an additional tax equal to 20% of the compensation required to be included in gross income; and
- The tax due is increased by interest assessed on the tax underpayments, at Federal underpayment rate plus 1%, for the period beginning on the deferral date and ending when the deferred amount is deemed included in income.

Additionally, noncompliance with respect to one payment or benefit may taint other payments and benefits and subject them to the Section 409A penalties.

An employer may be subject to penalties and interest for failure to properly report income and withhold taxes.

IV. Public Companies

For "key employees" of a public company, payments that do not satisfy the short-term deferral rule or the separation pay safe harbor exemption *(see below)*, must be delayed for at least six months following separation from service. A key employee is defined under the Code as an officer earning more than $135,000 per year, a 5% owner, or a 1% owner with compensation greater than $150,000. Therefore, unless an exemption applies, to avoid the harsh tax penalties, key employees must delay the receipt of their severance pay and benefits until 6 months after they separate from service. The six-month delay rule must also be written into the plan.

V. Exemptions

Several exemptions apply under Section 409A, including the Short-Term Deferral Exemption and the Separation Pay Plan Exemptions. The Final Regulations to Section 409A allow for the "stacking" of exemptions from Section 409A. This means that the exemptions described below apply in combination, so that a given employee can receive exempt benefits under some or all of the exemptions.

A. Short-Term Deferral Exemption

A plan that requires that amounts be paid within a short period after they are fully earned and vested is exempt from Section 409A, under the short-term deferral exemption. This exception covers any plan under which compensation is required to be, and in fact is, paid within 2 ½ months after the end of the year in which it vests. The 2 ½ month period is measured from the end of the employer's taxable year or the end of the employee's taxable year, whichever is later. Under this exemption, lump sum severance pay upon termination without cause or termination for good reason could be qualified. This exception also means that many bonus arrangements are not considered nonqualified deferred compensation plans for purposes of Section 409A. Moreover, if this exception is available, the required six-month delay for key employees of public companies will not apply.

B. Separation Pay Safe-Harbor Exception

Section 409A includes a safe-harbor provision that exempts certain separation payments from deferred compensation subject to Section 409A. The Separation Pay Plan Safe-Harbor includes exceptions to:

1. Collectively bargained separation pay plans;
2. Involuntary separation or window program plans;
3. Foreign separation pay plans; and
4. Separation expense reimbursements and other payments.

1. Collectively Bargained Separation Pay Plan

The IRS granted special relief to nonqualified deferred compensation plans set up under collectively bargained agreements. Separation pay agreements that are collectively bargained and that provide benefits upon an actual involuntary separation from service, or pursuant to a voluntary window program, are not considered an arrangement that provides for deferred compensation and thus are not subject to Section 409A.

A collectively bargaining separation pay plan must meet the following conditions:

1. It is contained within a valid collective bargaining agreement;
2. The separation pay provided by the collective bargaining agreement was the subject of arms' length negotiations between employee representatives and employers; and
3. The circumstances evidence good faith bargaining between adverse parties.

2. Involuntary Separation

A separation pay plan that provides for separation pay only upon an actual involuntary separation from services or pursuant to a window program is exempt from 409A, as long as it meets the specific requirements:

1. The separation pay (other than reimbursements and amounts paid under a foreign separation play plan) may not exceed the lesser of:
    a. two times the departing employees' annual compensation for the prior calendar year; or if less,
    b. two times the qualified retirement plan maximum compensation limit under Internal Revenue Code §401(a)(17) (currently $230,000 – so twice the limit is $460,000 for 2008), for the year in which the service provider has a separation from service; and
2. The separation pay must be paid in full by no later than December 31 of the second calendar year following the calendar year in which the termination occurs.

An arrangement that provides for severance pay other than on an involuntary termination (i.e. provides for severance pay upon a voluntary resignation) is not eligible for this exception, even if the actual trigger to the payment is in fact an involuntary termination.

Whether termination is involuntary is based on the specific facts and circumstances. An "involuntary termination" includes being fired by the employer, as well as a termination instigated by the employee, provided the employee has an acceptable "good reason" for the decision to leave. This means that generally, a good reason quit will be treated as an involuntary termination if the good reason involves employer action that results in a material negative change to the employee's relationship with the employer, and the termination was the result of this bona fide good reason condition, rather than to avoid Section 409A requirements.

Section 409A also provides a safe harbor to establish with certainty a good reason termination. A good reason quit is treated as an involuntary separation if the plan requires that:

A. The separation from service must occur within a limited period of time (not to exceed two years) following the existence of one of the following good-reason conditions:
    1. A material diminution in the employee's base compensation;

2. A material diminution in the employee's authority, duties or responsibilities;
3. A material diminution in the authority, duties or responsibilities of the supervisor to whom the employee is required to report;
4. A material diminution in the budget under the employee's control;
5. A material change in geographic location of the employee's work; or
6. A material breach by the employer of the terms of the employment agreement.

B. The amount, time and form of payment upon good-reason separation must be substantially identical to the amount, time and form of payment upon involuntary termination; and

C. The employee is required to give the employer notice of the existence of the good reason condition within 90 days after the condition arises, and a reasonable opportunity, at least 30 days, to cure the condition.

The final regulations establish a rebuttable presumption that the employer and employee's characterization of the separation from service as voluntary or involuntary is proper.

Window Programs

Both of the exceptions for involuntary separation and collectively bargained plans outlined above, are available for benefits paid on involuntary termination of employment, as well as pursuant to a window program. A window program refers to a program established by the employer, for a period of no more than one year, to provide for separation pay to certain employees who separated from service during that period under specified circumstances. Such programs are often referred to as VERPS (Voluntary Employee Retirement Programs). Even though termination of employment pursuant to a window program is typically a voluntary termination, separation pay pursuant to one of these safe harbor arrangements in connection with a window program is not subject to Section 409A.

3. Foreign Separation Pay Plans

A separation pay plan, including a plan providing payments upon a voluntary separation from service, is exempt under Section 409A to the extent the plan provides for amounts of separation pay required to be provided under the applicable law of a foreign jurisdiction.

4. Separation Expense Reimbursements and Other Payments

Certain reimbursement payments made in connection with a separation of service are exempt from Section 409A. Under Section 409A the following reimbursements are excluded from Section 409A, as long as the expenses are incurred by the terminated individual no later than December 31 of the second calendar year following the calendar year in which the termination occurs and reimbursed before the end of the third calendar year:

- Reimbursements that are otherwise excludible from gross income;
- Reimbursements for expenses that can be deducted as business expenses; and
- Reimbursements for reasonable outplacement expenses and reasonable moving expenses.

In addition, reimbursements for medical expenses will also be excluded from Section 409A so long as the reimbursements apply to expenses incurred during the period that the employee would be entitled under COBRA to continue health coverage under the employer's health plan (generally 18 months following termination of employment or eligibility for another employer's group health plan coverage, if earlier). Also excludable from Section 409A are reimbursements, payments and benefits that do not exceed the dollar limit on elective contributions to a 401(k) plan ($15,500 for 2008).